

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF NEW YORK

In re:

Nicholas Domenici &
Robin Domenici,

Debtors.

Eastern Funding, LLC.

Plaintiff,

- against -

Chapter 7

Case No.: 99-10829

Adversary Pro. No.: 99-91127

Nicholas Domenici & Robin Domenici,

Defendants.

APPEARANCES:

Law Offices Ferro & Kuba, P.C.
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Of Counsel

Hon. Robert E. Littlefield, Jr., United States Bankruptcy Judge

Memorandum, Decision & Order

Before the court is an adversary proceeding initiated by Eastern Funding (“Creditor”) seeking a determination that certain debts owed to it by Nicholas and Robin Domenici (“Debtors”) are nondischargable. The Creditor relies on 11 U.S.C. §§ 523(a)(2)(A) and (B).

Facts

Based upon the pleadings before it and the evidence adduced at trial, the court finds the following:

1. In October 1997, the Debtors began negotiating with the Creditor for an equipment loan, culminating in the Debtors applying for an \$85,000 loan on March 18, 1998 (the “first loan”).
2. Based upon the financial information provided by the Debtors, the Creditor funded the first loan. The \$85,000 was paid directly to an equipment vendor with the Creditor retaining a purchase money security interest.
3. The Debtors commenced regular monthly payments on the first loan.
4. On or about August 25, 1998, Debtor Robin Dominichi telephoned the Creditor, seeking to alter the payment terms on the first loan. She explained that she and her husband had invested a substantial amount of their own money into expanding the business, draining their working capital, and that they needed additional funds for further expansion. The Creditor suggested that the Debtors take a second loan rather than altering the payments on the first loan.
5. After this phone call, an employee of the Creditor met personally with the Debtors. At this meeting, the Debtors reiterated that the business was doing well, that they had invested a substantial amount of their own funds into the business and that they needed the additional money to further expand the business. The Debtors also provided documents purporting to substantiate these assertions.
6. Based upon these representations and documentation, on September 8, 1998, the Creditor funded the additional loan for \$75,000 (the “second loan”).
7. The Debtors defaulted on the first payment due on the second loan which came due on October 15, 1998. Moreover, in October 1998, the Debtors sold their home and their business.
8. In February 1999, the Debtors filed a joint Chapter 7 petition.
9. On May 14, 1999, the present adversary complaint was filed. The Debtors filed a MOTION TO DISMISS. The motion was denied. On April 17, 2000, a scheduling order was issued calendaring the trial for September 26, 2000 and directing both parties to provide the court and their adversary with pretrial submissions by September 15, 2000. Neither party complied with this directive.

10. On September 20, 2000, the court received a letter from Creditor's counsel requesting that the court adjourn the trial. Counsel was advised that to have its request considered, a motion on shortened notice would have to be submitted because the court would not consider moving a scheduled trial based upon a letter. On September 21, 2000, the paperwork was submitted. On September 22, 2000, the court held a hearing and determined that the trial was to proceed on the scheduled date, September 26, 2000. Creditor's counsel was sanctioned \$1,500 but was allowed to file late pre-trial submissions. The Debtors were also allowed to file late pre-trial submissions.
11. On September 26, 2000 the trial was held; decision was reserved and a briefing schedule established. The matter was fully before the court on March 15, 2001.

Arguments

The Creditor argues that the documentary evidence and the testimony at trial establishes the requirements of both 11 U.S.C. §§ 523(a)(2)(A) and (a)(2)(B) and postulates that once its evidence was presented the burden shifted to the Debtors to refute the allegations. It also contends that the Debtors should not benefit by their nonappearance at trial.

The Debtors, not surprisingly, argue the opposite. They contend that the Creditor has failed to establish the elements of 11 U.S.C. § 523(a)(2)(B) and that subsection (a)(2)(A) is inapplicable.

Discussion

As will be discussed in further detail, the court determines that the Creditor has not met its burden under either subdivision of § 523 regarding the first loan (March 1998 – \$85,000) and that debt is discharged. With respect to second loan (August 1998 – \$75,000), the Creditor has established 11 U.S.C. § 523(a)(2)(A) is applicable and has satisfied its requirements. Thus, this debt is nondischargeable.

Procedural Background

This case is an excellent example of what litigants appearing before this court should not do. On May 14, 1999, the complaint initiating this adversary was filed. On July 6, 1999, the Debtors filed a MOTION TO DISMISS FOR FAILURE TO STATE A CLAIM. After several hearings had been adjourned at the request of the parties, the court heard and denied the MOTION TO DISMISS. On April 17, 2000, after the Creditor's attorney failed to submit a written order, the court issued its own order denying the motion. At the same time, the court issued a scheduling order calendaring the trial for September 26, 2000.

As previously noted, on September 20, 2000, Creditor's counsel in New York City requested a 60 day adjournment of the trial because of a problem with its local counsel.¹ Creditor's counsel was informed that the court does not adjourn trials, absent justification, and was instructed that to have its request considered, a motion on shortened notice should be submitted. On September 22, 2000, the court held a hearing on the request and determined that the trial was to proceed on the scheduled date. The Creditor and the Debtors were allowed to make late pre-trial submissions. On September 26, 2000, the evidentiary hearing was held, decision was reserved and a briefing schedule determined.

It must be noted the Debtors argue that they had no obligation to submit any paperwork because the Creditor/Plaintiff had failed to make the necessary submissions. The court disagrees. It is true that a plaintiff has the initial burden of proof and ordinarily drives a case. However, this court's scheduling order applies equally to plaintiffs and defendants and, therefore, both parties

¹The Creditor obtained new local counsel in September 2000.

are expected to submit the required documentation.² If either party fails to make the pre-trial submissions then they are in violation of the scheduling order and, pursuant to paragraph 12, subject to sanctions.

11 U.S.C. § 523

The Creditor invokes 11 U.S.C. §§ 523(a)(2)(A) and (B), arguing that they govern the present matter. This section and its subdivisions state:

- (a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt -
 - (2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by -
 - (A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition;
 - (B) use of a statement in writing -
 - (i) that is materially false;
 - (ii) respecting the debtor's or an insider's financial condition;
 - (iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and
 - (iv) that the debtor caused to be made or published with intent to deceive.

The Debtors argue that 11 U.S.C. § 523(a)(2)(A) is inapplicable because the controversy concerns oral statements regarding the Debtors' financial condition and thus are "not actionable under this section." (Debtors' Memorandum p. 7.) The court disagrees and for the following reasons finds that the statements were not "regarding the debtors' financial condition, and thus, subdivision (a)(2)(A) is applicable and controlling."³

²These submissions could accompany a motion to preclude.

³Since the court has determined that 11 U.S.C. § 523(a)(2)(A) controls, the remainder of this decision deals only with that subdivision.

Courts have grappled with the phrase “a statement respecting the debtor’s or an insider’s financial condition” because “financial condition” is not defined in the Bankruptcy Code. Differing lines of thought have emerged. The most persuasive, in this court’s view, is a strict interpretation of the term which limits its application to financial type statements including balance sheets, income statements or overall income and debt statements which are meant to demonstrate a person’s ability to pay a debt. This interpretation gives financial condition its “normal commercial meaning and usage” and is supported by the floor statements made by the sponsors of the Bankruptcy Reform Act of 1978. *In re Sansoucy*, 136 B.R. 20, 22 (Bankr. D.N.H. 1992); *See also In re Soderlund*, 197 B.R. 742 (D. Mass. 1996); *In re Alicea*, 230 B.R. 492 (Bankr. S.D.N.Y. 1999) (collecting cases). Moreover, this narrow view is better suited to promote the fundamental bankruptcy policy of giving an ***honest*** debtor a fresh start because adopting the more expansive view, as urged by the Debtors, would allow manipulative debtors, savvy enough to refrain from reducing their misrepresentation to writing, to escape the anti-discharge provisions completely. *In re Alicea*, 230 B.R. at 501. This result could not have been intended by the drafters of the Bankruptcy Code. For all these reasons, the court determines that the Debtors’ statements were “other than a statement respecting their financial condition” and, therefore, 11 U.S.C. § 523(a)(2)(A) controls.

In interpreting 11 U.S.C. § 523(a)(2)(A), courts have concluded that to be successful, a party must demonstrate, by a preponderance of the evidence, that:

1. the debtor made a representation;
2. he knew the representation was false;
3. he intended to deceive the creditor;

4. the creditor relied on the representation; and

5. his reliance was the proximate cause of his damage. *In re Luthra*, 192 B.R. 88 (E.D.N.Y. 1995) (citing *In re Schwartz & Meyers*, 130 B.R. 416 (Bankr. S.D.N.Y. 1991)). The Debtors argue that the Creditor has failed to demonstrate that the representations were false, the statements were intended to deceive, and that the Creditor's reliance on them was reasonable.⁴ With respect to the first loan the court agrees; with regard to the second loan it does not.

First loan

The Creditor argues that when applying for the first loan, the Debtors represented that they were going to invest approximately \$100,000 into the business and that Mr. Dominichi had discontinued pursuing a loan from the People's Bank. The Creditor further alleges that the Debtors failed to disclose a promissory note due to them was in default.

These troubling allegations notwithstanding, the Creditor has failed to establish that the Debtors knew the statements were false when they were made. Moreover, the Creditor has also failed to demonstrate that it relied on the representation that Mr. Domenici had discontinued pursuing the loan from the People's Bank. The Creditor merely states, "Nicholas Domenici also stated that he had stopped pursuing a bank loan that he was seeking a loan from only the plaintiff ... The truth was that the defendants were pursuing a loan that had to be repaid to People's

⁴The Debtors also argue that none of the representations are attributable to Debtor Nicholas Domenichi and, therefore, the debts should be dischargeable with respect to him. However, the Debtors offer no legal support for this theory and, therefore, the court will not treat these Debtors distinctly, especially when the Debtors listed this debt on a joint bankruptcy petition.

Bank...” (Creditor’s Post Trial Brief p. 3.)⁵ The Creditor does not offer sufficient evidence of how it relied on this representation and how this reliance was the proximate cause of its damage, and thus, the Creditor has failed to meet its burden.

Finally, with respect to the first loan, the Creditor argues that the Debtors failed to disclose a default in a promissory note where they were payees. The Creditor argues that this false statement inflated the Debtors’ net worth and that the Creditor relied on this misrepresentation to its detriment. However, the Creditor has failed to show that the statements were false when made, that the Debtors knew they were false or that the Debtors made the representation with the necessary intent.

Second loan

To demonstrate that Debtor Robin Domenici’s representations, with respect to the second loan, were false the Creditor urges the court to examine the Debtors’ bankruptcy petition and schedules⁶ signed under the penalty of perjury. The uncontradicted testimony at trial indicates that Debtor Robin Domenici made several representations in connection with the second loan. The first statement was that the loan was necessary for expansion and that the business was generating thousands of dollars of weekly income. However, a review of the bankruptcy petition indicates that the Debtors’ business closed in October 1998, less than one month after receiving the second loan and less than two months after the representation. Absent explanation, it is

⁵The statement is taken verbatim from the pleadings, the court has not made any grammatical changes.

⁶At the evidentiary hearing, the Creditor requested that the court take judicial notice of the petition and schedules. The Debtors initially objected but then withdrew the objection, conceding that the petitions and schedules are part of the court’s file and record. (Tr. 38.)

difficult to imagine a situation where a business closes its doors two months after considering expansion and while generating a positive cash flow.

The Creditor also takes exception with the Debtors' representation that they had invested a substantial amount of their own money into the business. The main controversy revolves around a representation, embodied in trial exhibit 8,⁷ wherein Debtor Robin Domenici indicated that the \$100,000 they had deposited in their corporate account in April 1998 had been derived from sale of their stocks. Once again, the petition and schedules lead to a different conclusion. On Schedule F, the Debtors listed a loan owed to the People's Bank in the amount of \$100,000. The Statement of Financial Affairs indicates that this loan closed on April 9, 1998. A copy of the bank statement⁸ for the Debtors' corporation shows only one deposit of \$100,000 in April 1998 occurring less than one week after the People's Bank loan closed for that amount. Without contrary evidence, the logical conclusion is that the \$100,000 constituted the proceeds of the loan and not, as represented by the Debtors, an investment of personal funds derived from the sale of stocks.

Having determined that the statements were false does not end the inquiry. Next is whether the false statements were made with an intent to deceive. Courts are aware that a debtor will not admit to harboring such an intent. Therefore, the objecting party may prove it by circumstantial evidence. *In re Bonnanzio*, 91 F.3d 296 (2d Cir. 1996). Furthermore, an intent to

⁷The court is cognizant that this written statement, arguably, could be addressed by 11 U.S.C. § 523(a)(2)(B). However, the court reiterates its previous discussion regarding 11 U.S.C. § 523(a)(2)(A). This subdivision is not limited to either oral or written statements and governs the current controversy.

⁸Creditor's Exhibit 7, admitted without objection.

deceive can be inferred from the totality of circumstances, including an individual's reckless disregard for the consequence of their actions. *Id.* at 300.

The Creditor relies simply on the evidence that the Debtors represented that they had invested their own funds into their business, that the business was doing well and that the additional money was needed for expansion. One month after receiving the \$75,000, the Debtors sold their home⁹ and several businesses and engaged in evasive behavior. An employee of the Creditor testified as follows:

Q. When did you disburse these funds?

A. I believe it was either September 8th or within one or two days thereafter.

Q. And what happened after making that loan?

A. They made a first payment default which is almost unique in my years of lending money. They failed to make the first payment. They closed the store and just left.

Q. When was the first payment due?

A. October 15th.

Q. And that payment was not made?

A. No.

Q. What did you do then?

A. Well, I called Nicholas Domenici after I could not reach Robin Domenici, there was no answer at the phone. I reached Nick at the store. He said - -

Q. When was this?

A. This was in mid-October, probably on the October 20th because the payment was due on the 15th and we had automatic payments, directly

⁹This fact is taken from the Debtors' Schedule "A."

authorized out of their checking account by the Debtor. And we find out within three days if they bounce. So on the 18th it bounced. I tried to call Robin, naturally, I was very alarmed because we had just made a loan of \$75,000 which should have been adequate working capital for at least six months. ... I called Nick and he just said Robin would have to get back to me. He didn't say anything was wrong. Then I couldn't reach him again and could never reach Robin. Two days later I drove to the store and saw to my shock the store closed sign saying - - (Tr. 27- 28.)

....

Q. What did you do after going into the store at the end of October?

A. I drove to their home ... and I drove to the stores that they had owned in Southington, Connecticut and found that they had sold them ... (Tr. 29 - 30.)

The court finds this testimony to be credible and based upon all of the facts, (e.g., the Debtors selling their home and business, the first month default on the second loan, the Debtors' failure to affirmatively contact the Creditor, and their evasiveness) the court concludes the totality of the circumstances demonstrates the Debtors harbored the necessary intent to deceive.

The Debtors argue that it was not reasonable for the Creditor to rely, without verification, on their representations with respect to the second loan. (Debtors' Memorandum p. 8.) However, reasonable reliance is a requirement of subdivision (a)(2)(B); subdivision (a)(2)(A) only requires actual reliance and a demonstration that the reliance was the proximate cause of the damages. *In re Luthra*, 192 B.R. at 91 (citations omitted). The testimony indicates that the Creditor required verification that the Debtors had invested their own money into the business and that it was doing well. (Tr. 24-29.) The Debtors responded with a faxed letter¹⁰ and a copy of a bank statement.¹¹ This verification was necessary to determine the lender's loan to value

¹⁰Creditor's Exhibit 8.

¹¹Creditor's Exhibit 7.

ratio. (Tr. 24.) The Debtors' representations led the Creditor to determine it had a sixty percent loan to value ratio. (Tr. 24.) Based upon this ratio and other factors, including the Debtors' payment history, the Creditor extended the loan. The Creditor credibly testified that it would not have issued the loan if it had known the true ratio. The loan to value ratio proved to be incorrect and was the proximate cause of the Creditor's damage. Thus, the Creditor has established subdivision (a)(2)(A)'s necessary reliance.

The Debtors' Silence

The Debtors did not appear at the evidentiary hearing. Their attorney argues that it would have been ill-advised for them to appear and be to be called as witnesses because no depositions had been conducted. The Creditor counters that the Debtors should not be allowed to benefit from their lack of appearance. The court recognizes this dilemma, however, in light of what was produced at trial, it was incumbent for the Debtors to come forth with some explanation. The Second Circuit has stated, "[O]nce a creditor establishes a *prima facie* case of fraud, the burden of coming forward with some proof or explanation to the alleged fraud shifts to the debtor." *In re Furio*, 77 F.2d 666, 624 (2d Cir. 1996.) (citations omitted). Here, no explanation was offered.

For the above reasons, the court concludes that the Creditor has failed to establish that any statement by the Debtors made in obtaining the first loan was false and, therefore, that debt is discharged. However, the Creditor has proven the requirements of 11 U.S.C. § 523(a)(2)(A) with respect to the second loan and that debt is nondischargeable.

Dated:
Albany, New York

Hon. Robert E. Littlefield, Jr.
United States Bankruptcy Judge

